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Corporate financial policies and the exchange rate regime: Evidence from Brazil

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ABSTRACT

This paper analyzes the relationship between companies' financial policies and the exchange rate regime for a sample of non-financial Brazilian companies from 1996 to 2006. The adoption of a floating exchange rate regime is shown to improve the match between the currency composition of companies' assets and liabilities. The paper also shows that this reduction in companies' currency mismatches is more pronounced for companies in the highest quantile of foreign exposure; therefore the results confirm that the exchange rate regime plays an important role in the determination of companies' foreign vulnerability.

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1. Introduction

Adverse external shocks represent a key source of risk for emerging markets. In these countries, several episodes of crises and economic downturns were triggered by external factors.¹ Examples are an abrupt rise in global interest rates, a fall in commodity prices or a weakening of global growth. One question levied by the literature is whether the exchange rate regime plays a role in reducing countries' vulnerability to these shocks.

Following a sequence of financial crises in the 1990s, a new generation of currency crises models placed corporate behavior at the center of the debate about the relationship between countries' external vulnerability and the exchange rate regime. In these models, a fixed exchange rate regime would increase

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¹ Examples are an abrupt rise in global interest rates, a fall in commodity prices or a weakening of global growth.

countries' vulnerability by leading companies to disregard the exchange rate risk, biasing their borrowing towards foreign currency denominated debt and/or reducing their hedging activities. In opposition, a floating exchange rate regime would help countries to mitigate their external vulnerability by inducing companies to take seriously their exchange rate exposure.

Since these models argue that this behavior would arise due to the guarantees given by the government to companies, this branch of the literature has denominated the implicit guarantees hypothesis. Examples of this literature include [Dooley \(2000\)](#), [Burnside et al. \(2001\)](#), [Schneider and Tornell \(2003\)](#) among others.

In a similar direction, [Caballero and Krishnamurthy \(2003\)](#) point out that the lack of financial development in emerging countries is an important factor in determining the share of the debt determined in foreign currency. In their model, financial constraints induce agents to undervalue insuring against exchange rate devaluations, leading to excessive foreign currency denominated debt.

Departing from moral hazard issues, [Ize and Levy-Yeyati \(2003\)](#) argue that in a minimum variance portfolio equilibrium, financial dollarization is a function of the relative volatility between the real exchange rate and inflation. Considering that fixed exchange rate regimes are associated to lower real exchange rate volatility, these regimes would lead to higher financial dollarization.

Contrasting to these models, [Eichengreen and Hausmann \(1999\)](#) discuss that the choice of the exchange rate regime is of second order importance in determining countries' external vulnerability. The "original sin" literature asserts that currency mismatches arise as the result of the functioning of international financial markets and countries are not able to change this problem by the adoption of domestic economic policies.

Some authors also advocate a relationship in the opposite direction. Currency mismatches would lead countries to restrict the fluctuations of the exchange rate; therefore, countries with higher levels of currency mismatches would present a "fear of floating" ([Calvo and Reinhart, 2002](#)). In [Moron and Winkelried \(2005\)](#) and [Cook \(2004\)](#) the authors show that in equilibrium higher levels of currency mismatches lead to lower exchange rate flexibility.

Combining the two literatures, [Chang and Velasco \(2006\)](#), [Ize \(2005\)](#) and [Cowan and Do \(2003\)](#) show that fear of floating and currency mismatches are two sides of the same coin where the two facts took place simultaneously and are difficult to disentangle from each other.

To what extent the exchange rate regime can alleviate companies' foreign vulnerability by inducing changes in corporate financial policies is still an open question.

Empirical studies in this area are still scarce. [Martinez and Werner \(2002\)](#) found that after the financial crisis in Mexico in 1995, companies reduced the currency mismatches in their balance sheets. Performing a similar test than [Martinez and Werner \(2002\)](#) for Brazilian companies between 1996 and 2004, [Rossi \(2007\)](#) confirms that implicit guarantees linked to the adoption of a fixed exchange rate regime biased corporate borrowing towards foreign currency denominated debt and that the floating regime alleviates this problem, leading companies to take seriously their foreign exposure. Similar results were found by [Cowan et al. \(2005\)](#) for a sample of Chilean companies. The authors found that there was a reduction in the level of currency exposure after 1999 when the home currency was let to float. The authors argue that this reduction in exposure took place due to the fact that the floating regime eliminated implicit exchange rate insurance given to firms, forcing them to internalize the exchange rate risk. Also confirming the moral hazard view, [Patnaik and Shah \(2008\)](#) found that Indian companies hold more currency mismatches on their balance sheets in periods of lower exchange rate volatility.

Departing from country-case studies, [Arteta \(2005\)](#) finds in a cross-country sample that bank deposit dollarization is greater under floating regimes, while credit dollarization does not appear to differ across regimes; therefore, he finds little support for the view that flexible exchange rate regimes reduce currency mismatches. [Kamil \(2006\)](#) confirms using a sample of companies in seven different Latin-American countries that the adoption of a floating exchange rate regime leads to a higher degree of currency matching on companies' balance sheets.

[Parsley and Popper \(2006\)](#) estimating companies' exchange rate exposure found that the adoption of a flexible exchange rate regime also reduces the number of companies with significant exposure to fluctuations of the exchange rate. In addition, [Luca and Zhang \(2006\)](#) using a panel containing data on emerging and developing countries from 1975 to 2000 confirm the two-way relationship between currency mismatches and exchange rate flexibility. They find that mismatched bank portfolios generate fear of floating and this fact leads to an increase in currency mismatches.

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